

Labor Market Policy and Institutions: Combining Protection with Incentives for Job Creation

Enhancing job opportunities requires an adaptable labor market in which firms have the right incentives to create more jobs and workers receive support when coping with labor mobility. Improving the adaptability of the labor market requires interventions in several areas: wage determination and labor taxation, employment protection legislation, and social safety nets for the unemployed.

Although most transition economies of the Region have carried out significant labor market reforms over the past decade to improve labor market adaptability, there is substantial room for improvement. In most countries in the Region, employment relations are still over-regulated, discouraging hiring. Much of the labor market flexibility comes from nonenforcement. In many countries, especially in SEE and the CIS, wage bargaining is not conducive to swift wage adjustments to changing demand-and-supply conditions. High taxes on labor, especially in CEE, discourage labor demand. Income support to the unemployed can be provided in a more efficient way, to provide protection to displaced workers and to encourage job reallocation, which is of particular importance in the CIS. Further labor market reforms are thus necessary to enhance the ability of the transition economies to cope with various shocks. Also, the reforms of the pension and health insurance systems need to be continued to make possible the reduction in labor taxation.

The chapter is organized as follows. Section 1 provides a brief discussion of the roles of labor market policies and institutions. Section 2 focuses on wage determination. Section 3 examines employment protection legislation in the Region. Section 4 deals with labor taxation. Section 5 analyzes active and passive labor market policies. Section 6 suggests direction for labor market reforms for the Region's subgroups.

The Role of Labor Market Policies and Institutions

Labor market policy and institutions are important, both in their potential impacts on labor market adjustment and in the incentives that they give firms (see box 6.1). They have direct and indirect impacts on wages, which in turn can be expected to influence both the structural level of (un)employment and the speed of labor market adjustment to shocks. Policies and institutions can impact wage and employment adjustment in a variety of ways, including truncating the lower end of the wage distribution (with impacts on the level and structure of employment), affecting firm incentives for hiring and firing, promoting (re)entry to employment for laid-off workers and new entrants, and affecting labor supply incentives. The interaction of different labor market institutions in specific country settings further complicates the analysis of the impact on labor market outcomes.¹

In a context of major economic restructuring such as in the transition economies of the Region, the government has a role to play in balancing policies that facilitate the allocation of workers to more-productive jobs with policies that are designed to help workers cope with necessary adjustments. Most of the Region's countries have undertaken major reforms of labor market institutions during the transition, although the extent of reform has varied by subgroup and by specific element of the institutional framework. Despite reforms, excessive institutional rigidities appear to have contributed to unemployment among the low-skilled and in depressed regions and to have affected patterns of labor adjustment. However, they cannot be considered the primary cause of low labor market performance in the Region, which appears to be driven more by low labor demand, an unfavorable business environment, skills mismatch, and other factors.

The Divergent Paths of Wage Determination during the Transition

In market economies, a higher unemployment rate will have a dampening effect on wages: as outside options become less favorable,

BOX 6.1**The Role of Labor Market Policies and Institutions: Some International Evidence****Social Dialogue and Wage Bargaining**

As illustrated by the experience of Western Europe and countries like Poland and South Africa, unions have a crucial role to play in promoting macro and structural reforms, as well as political openness and democracy. However, depending on the economic and social environment in which unions operate, collective bargaining has been found to affect the flexibility of wages and the performance of firms.

Union wage markup (a premium over the wage of similar workers in nonunionized firms) is an important indicator of union bargaining power and ability to influence labor market outcomes. The evidence suggests that union wage markups are small in industrial countries, but high in countries that have weak competition in output markets and large rents. For example, wage premiums are high in Bulgaria and Malaysia (5–20 percent) and South Africa (10–24 percent), but low in Korea (2–4 percent). High union wage premiums obviously benefit union members at the expense of the unemployed; however, wages set at above the competitive level lower labor demand and lead to less employment.

Unions also have other impacts. For example, in Mexico, unions have attempted to protect low-skilled jobs at the expense of higher productivity. In Guatemala, unionization is associated with lower productivity of coffee farmers. In Brazil, the improvement in productivity and profitability resulting from the greater participation of workers in certain aspects of company management was enhanced in unionized companies because unions facilitated communication between management and workers.

The level at which negotiations take place (firm, sector, or country) is also important. Experiences of developing and industrial countries have shown that sectors (industries) do not coordinate their wage demands, decreasing aggregate and relative wage flexibility.^a To alleviate these effects, some industrial countries have reinforced the coordination between the different levels of bargaining. For example, in Denmark, Ireland, and the Netherlands, the basic wage increase is fixed through nationwide agreements, while further increases consistent with a firm's performance are left to firm-level negotiations. Following the systems in countries like Australia, New Zealand, and the United Kingdom, others have chosen to reinforce firm-level bargaining, which is more likely to reflect firms' and workers' performance.

Minimum Wages

Minimum wages have been found to have disemployment effects, small in aggregate, but significant among low-productivity workers. For example, in industrial countries, where minimum

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BOX 6.1 (continued)

wages tend to be relatively low, they had a modest impact on low-technology firms and the employment of low-productivity workers. In Colombia, for every percentage point rise in the minimum wage, employment has been estimated to fall by 0.15 percentage points. In Indonesia, the significant increases in provincial minimum wages led to a fall in employment in small firms, but not in larger firms, although it was also associated with an increase in the number of workers below the minimum wage. At levels close to the average wage (as in several low-income countries), many private firms, especially those in low-technology activities, cannot afford to comply. In middle-income countries, the minimum wage is generally about half the average in the formal sector. Its coverage and enforcement tend to be low, but its impact on low-productivity firms and jobs can be large. In Latin America, for example, the largest proportions of workers who earn less than the minimum wage are found in countries where it is comparatively high: in Paraguay (where most workers earn less than two-thirds of the minimum wage), Nicaragua (40 percent of workers below the minimum), and Colombia (25 percent).

Employment Protection Legislation

The protection offered to permanent workers and the conditions for temporary employment vary considerably across and within regions. Countries in Latin America, Eastern Europe, and Central Asia tend to offer the most employment protection for permanent workers. By contrast, English-speaking industrial countries and East Asian economies have the lowest statutory protection. Evidence from several countries that recently reformed their stringent labor regulations suggests beneficial effects. By moving their employment protection legislation closer to the standards of the European industrial countries in the 1990s, Colombia and Peru experienced a higher response of employment-to-output growth, with speedier employment adjustment but also positive employment effects. The reform in Colombia also contributed to increased compliance with labor legislation by lowering the costs of formal production. During the past decade, Italy and Spain have eased their restrictive firing regulations, which has led to sizable positive effects on employment.

Source: Pierre and Scarpetta 2004b.

a. Each bargaining unit is strong enough to push wages above productivity, but at the same time, it is vulnerable to other units' wage strategies without being able to influence them.

workers' bargaining power is decreased. Under Communism, except for the former Yugoslavia, unemployment was essentially nonexistent, and wages did not respond to firms' performance.

The negative relationship between unemployment and wages, commonly called the "wage curve," appeared during the 1990s in several CEE countries (for example, Bulgaria, Hungary, Poland, and Slovenia), indicating that wages have become responsive to local labor market conditions.² But no such relationship exists in countries

that have been less advanced in their market reforms (for example, Romania). A wage curve also exists in Turkey, except for women and young workers, pointing to the specificity of their labor force participation and working conditions.³ In the central-planning period, because of the passive roles of unions and managers, there was no wage bargaining as such, but rather centralized wage setting, which mirrored price setting throughout the economy.⁴ Although the countries of the Region began the transition with very high union membership, the monolithic official unions exerted no independent influence on wages, being integrated into management structures and considered “transmission belts” for the authorities. Enterprise managers were also part of the planning apparatus, focusing on production and full employment objectives, rather than profits.

The evolution from a common starting point of government wage setting and passive unions and management has been mixed across the Region’s countries during the transition. What are the patterns and explanations for this? What is the evidence of the unions’ impact on labor market outcomes?

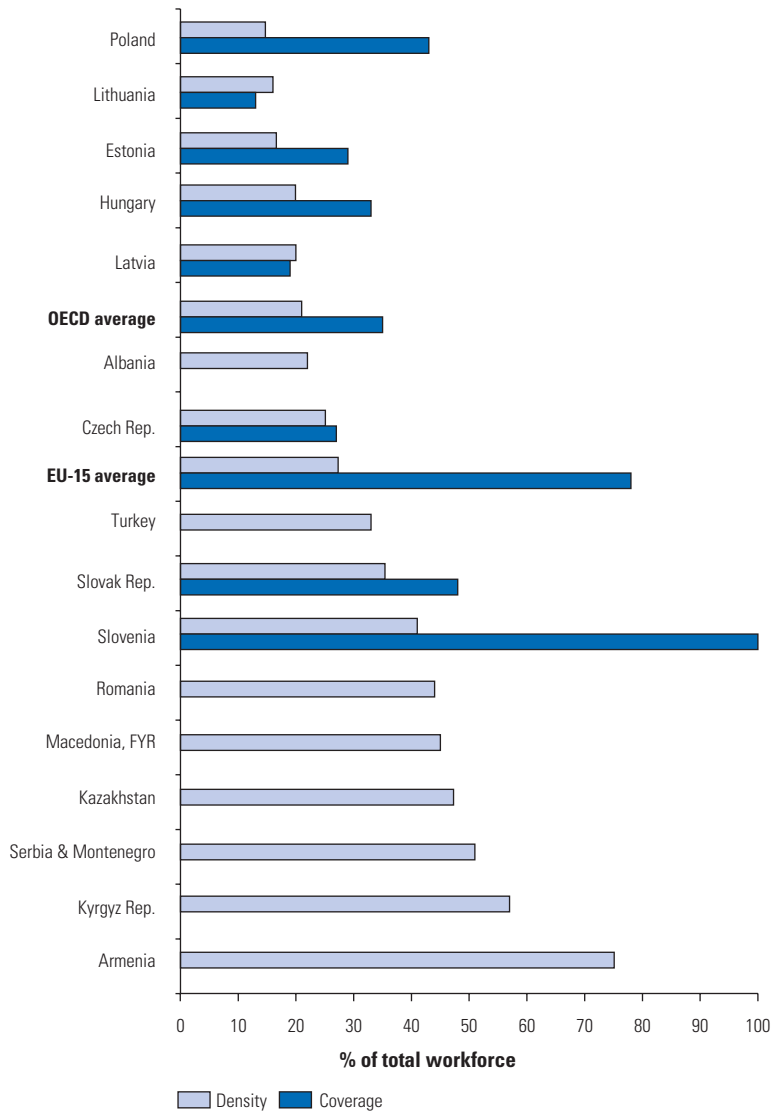
Falling Union Bargaining Power in Most Transition Countries

Union density and bargaining coverage⁵ have significantly declined in nearly all of the countries of the Region during transition, leading to diminishing impact of unions on wages. Under Communism, virtually all employees were members of the unions, and this was the case in most countries of the Region at the onset of the transition. As a new private sector developed, union presence and impact on wages declined in all transition countries, although there are clear subgroup variations in the extent of the decline. Figure 6.1 provides available information on density and coverage rates for a range of countries of the Region in the early 2000s.

The trends by subgroups are as follows:

- Official density rates in the waged sector in Belarus, Russia, and Ukraine and other CIS countries remain high by OECD standards (estimated between 55 and 90 percent), although effective coverage rates are likely to be lower, given large informal sectors and inflated membership numbers in most countries.⁶
- By contrast, average density and bargaining coverage rates fell more steeply in CEE, from more than 85 percent density and more than 90 percent coverage in most cases in 1989 to an average of around 30 percent density and less than 40 percent bargaining coverage by

FIGURE 6.1
Density and Bargaining Coverage, Early 2000s



Sources: EIRO (2004); ILO (2002) for CIS; OECD (2004a); Micevska (2004) for Albania, Serbia and Montenegro, and FYR Macedonia.

the early 2000s. There is also substantial variation within CEE, the Baltic States being down to around 20 percent coverage and Slovenia maintaining 100 percent by the early 2000s.⁷

- SEE countries also witnessed substantial declines in union density and bargaining coverage, though estimates from different sources vary. Reasonable estimates of average union density are 22 percent in Albania, 45 percent in FYR Macedonia, and 51 percent in Serbia and

Montenegro.⁸ Estimates of coverage rates have proven challenging to obtain. In some countries, such as Bosnia and Herzegovina (BiH),⁹ they remain very high in the formal sector, because of the strong role of general and sectoral collective agreements. Although more research is needed, this pattern may be typical of former Yugoslav countries, reflecting the residual influence of worker self-management and the role of trade unions prevalent under the former regime. In both BiH and Serbia and Montenegro (SAM), automatic extension of collective agreements to all workers was only eliminated with the reform of labor legislation over the past five years.

Despite declining membership, union bargaining strength in specific sectors has remained relatively strong. Examples include natural monopolies, transport, heavy industry, and mining, which have been more likely to stay in public ownership. In contrast, expanding sectors comprising largely private enterprises, such as trade, business, and personal services, have tended to have much lower union presence. Similarly, union presence in newly created small and medium enterprises is low.

The scale of the decline in union bargaining power in the transition countries reflects several influences:

- Structural change in the formal sector—specifically the emergence of large private sectors (with typically much lower density and coverage rates) and the growth of service sectors at the expense of traditional industrial sectors (where unions are more strongly represented)
- A pattern—stronger in CEE—of increased segmentation and fragmentation of unions and union confederations, often with conflicting political and economic agendas¹⁰
- The increased level of informal sector activity

The differential legal position of unions across the Region is an important factor in influencing their behavior. At one extreme, non-reformers, such as Turkmenistan, retain mandatory membership in the successor unions, with automatic union fee deduction from salaries. Others, such as Uzbekistan, inhibit the formation of independent unions through high membership thresholds for union registration. Azerbaijan controls union activism through legal prohibition of political activity.¹¹ Other countries, such as Estonia, have no such limitations on union formation or activity, but have eliminated the privileges for unions in bargaining that continue to exist in many other countries of the Region (see box 6.2).

BOX 6.2

Wage Bargaining in Estonia: A Radical Reformer

Because of explicit policy choices and a more general rejection of the Soviet inheritance, Estonia has seen the most fundamental changes in wage bargaining of any country of the Region. Together with Latvia and Lithuania, Estonia has witnessed the most dramatic decline in union density and bargaining coverage in the Region. By 2003, union density had fallen to around 16 percent, with 22 percent coverage. The private sector had only 8 percent density and around 19 percent coverage, in contrast to density and coverage rates of 28 and 31 percent, respectively, in the public sector. Although some sectors such as banking, construction, and services have very low unionization, others such as light industry, energy, education, and transport have strong unions, with much higher density. The small enterprise sector, which accounts for around 90 percent of private sector employment, has very limited unionization.

The low density and coverage, especially in the private sector, are partly the result of a lack of legal privileges for trade unions. This is reflected in the Collective Agreements Act of 1993, which abandoned the former union monopoly to conclude agreements and to represent workers at the enterprise level. There are no restrictions as to who may be elected or in which proportion to workers. This principle has been upheld not only for collective agreements, but also in later legislation on worker representation, such as the Trade Union Law of 2000. Estonian laws do not restrict union activity, but they do not stipulate any special bodies for codetermination or representation that are reserved for unions, the right to demand the conclusion of collective agreements, or any obligation on employers to enter collective bargaining.

Divergent Patterns of Change in the Wage-Bargaining Process across Subgroups

Changes in unionization and in the role of unions in the economy have often radically affected the process of wage setting in transition countries. As seen in chapter 2, all of the transition countries have experienced widening wage differentials resulting from transition, suggesting that, in aggregate, wage determination has become more flexible. However, the aggregate patterns mask substantial cross-country variation in the evolution of wage-bargaining arrangements:

- At one end of the spectrum, countries such as Belarus and Turkmenistan retain the inherited system, with wage setting in the formal sector being highly centralized and entirely controlled by the

Tripartite national bargaining began in 1992, with a Socio-Economic Council formed in 1999. Although the Council has a wide mandate to discuss economic issues, its only effective influence is on the minimum wage, the tax-free income threshold, and the level of unemployment benefit. For the public sector, negotiations focus only on the aggregate wage fund allocation, with substantial flexibility for employers to determine relative wages of workers beyond the minimum. The exception to date has been the education sector, where a more traditional wage coefficient structure has been retained in the face of a strong union. However, unions and employers accept the government view that budget and macroeconomic criteria are the primary determinants of wage outcomes. This can be seen in the large fluctuations in the real minimum wage during the second half of the 1990s and in the wage and pension freezes in the wake of the financial crisis in Russia. However, in 2001, there was a tripartite agreement on an increase in the ratio of minimum wage to average wage (MW/AW) from 32 percent in 2003 to 41 percent by 2008. Recent efforts of the government have focused on introducing performance-related pay, a move that has generally been resisted by the unions.

Beyond the national-level negotiations, private sector bargaining in Estonia happens almost entirely at the firm level. Given low union density and limited rights of representation, individual employment contracts have a major role in determining the wages of workers. As a result, there are often high wage differentials within firms, and unions include many workers with limited individual bargaining leverage (such as low-skilled or Russians whose language skills limit their work opportunities).

Source: Patzwaldt 2004.

government. A highly centralized model is also used in Slovenia, although the institutional mechanism is very different, leaving an important role for social partners in wage determination.

- At the other end of the spectrum, wage bargaining in most CEE countries has become highly decentralized in the growing private sector, and there are efforts to introduce more flexibility into public sector pay determination.
- Most of the other countries of the Region fall somewhere between these two extremes. Overall, Belarus, Russia, Ukraine, and other CIS countries still exhibit a strong legacy of socialist era wage determination in the formal sector. SEE countries represent an intermediate stage, with wage determination that is neither decentralized nor as dominated by government as in the CIS.

Compression of the Wage Schedule in the Public Sector

Key factors that distinguish the divergent evolution of wage bargaining in the transition countries include the size of public sector employment and the overall importance of government in economic decision making. The extent to which countries have reduced the role of the state in wage bargaining is thus the distinguishing feature of different subgroups of countries in the Region.

To assess the divergent subgroup developments, it is necessary to look first at public sector wage setting, because this has been the baseline wage determination mechanism from which countries have diverged at different speeds. Most of the transition countries have retained a coefficient-based system of wage determination in the public sector, under which wage adjustments cascade from adjustments in the base. This remains the model in Belarus, Russia, Ukraine, and other CIS countries and in SEE, with the public sector wage schedules exerting strong influence on formal private sector wage determination.¹² The coefficient system also applies in CEE public sector wage determination, although Estonia has eliminated the tariff schedule above the minimum in the public sector (except in education).

A key feature of such coefficient systems in most of the transition countries has been a compression of the wage schedule. Whereas the wage multiple from top to bottom of the public sector wage schedule in OECD countries has been around six to nine times, coefficient scales in the transition countries have typically been more compressed (for example, 2.3 in Romania, 2.8 in Moldova, 3.6 in Hungary, and so forth).¹³ This is an issue that many of the Region's governments have examined as part of civil service reforms, but as of the end of the 1990s, a significant share of countries still had high public sector wage compression.¹⁴

Spillover Effects in the Private Sector

The primary significance of the coefficient system in economic terms in the transition countries is not its direct impact via public sector employment. The share of public sector employment in most of the transition countries is not very large—albeit higher than the market-benchmark for countries at the same level of income per capita (see chapter 4)—and public sector wages have remained fairly low, despite some recent increases, especially in the CEE countries.¹⁵ However, the rigidities of the coefficient system assume wider significance in a labor market where there is a large state-owned sector that follows the same system, or where the formal private sector mimics the

public sector wage-setting mechanism. A strict coefficient system with strong wage compression clearly limits the scope for adjusting wages to relative productivity levels and regional labor market characteristics. To the extent that this characterizes much of formal sector wage determination (public and private), the economic impacts could be expected to be negative.

In practice, the coefficient system brings varying degrees of rigidity in wage determination across subgroups. The trends in wage determination in different subgroups of the Region are strongly associated with the residual share of public sector and SOE employment in total wage employment and the overall degree of government intervention in the economy.¹⁶

- In CEE, greater wage flexibility has been mainly the result of a substantial decentralization in formal private sector wage setting, coupled with product market liberalization and associated competitive pressure. The most notable exception is Slovenia, which retains 100 percent bargaining coverage and highly centralized wage setting, even in the private sector.¹⁷ In CEE countries, where wage-bargaining changes have progressed the most (for example, the Baltic States, the Czech Republic, Hungary, and Poland), enterprise-level wage bargaining developed spontaneously, largely in line with growth in the private sector and in the face of rather weak trade union influence at the firm level. For most CEE countries, wage bargaining takes place primarily at the enterprise level. The individual work contract is also a very important factor in the most-advanced reformers such as Estonia and Latvia.¹⁸ By contrast, the role of sectoral bargaining is generally limited in CEE countries, with the exception of the Slovak Republic and Bulgaria—with around 40 percent of the workforce covered by sectoral collective agreements—and Slovenia.¹⁹
- By contrast, in Belarus, Russia, Ukraine, and other CIS countries, the government remains a much more pervasive force in formal sector wage determination. The formal private sector has more closely followed the public sector's lead in wage determination. Unions have not (for the most part) evolved into independent forces in bargaining; they have retained a dominant role, but are almost entirely subject to the determination of wages by the government. Employers often continue to place employment retention above productivity gains, commonly mimicking public sector wage setting in the formal private sector. Although the situation varies across countries (for example, Kazakhstan has active inde-

pendent unions), the weakness of unions and employers is a shared feature of Belarus, Russia, Ukraine, and other CIS countries. As a result, they remain price takers from government in relation to formal sector wages and focus their efforts on negotiating soft budget constraints. At the same time, a large informal sector (accounting for more than 40 percent of employment) has provided very flexible wage determination for a large share of the workforce and is an important source of large wage disparities in the CIS. In Russia, flexible wage setting coexists with the use of the coefficient system in the private sector. Although most firms use firm-level wage scales, a significant fraction of private firms has adopted the public sector coefficient system.²⁰

- There is less information on wage-bargaining developments in SEE countries. Generally, in countries of the former Yugoslavia, unions have been relatively influential, in part because of the inheritance of self-management. At the same time, the role of the government in formal sector wage setting remains strong, either directly (as in BiH and SAM), or less directly through the wage pull of the SOE sector. This in part reflects a weak role of employers in central or sectoral wage bargaining in some SEE countries. In Bosnia and Herzegovina, the trade union confederations also have a strong influence on wage setting, in the face of still underdeveloped employer organizations and the strong influence of governments. Overall, the importance of general collective agreements in SEE continues to be strong, which both limits the impact of EPL reforms and prolongs wage-setting practices such as automatic seniority increases and large location bonuses. There is also a strong role for sectoral unions and bargaining, the presence of employers as an independent voice again being negligible. Serbia and Montenegro and FYR Macedonia provide examples of more-fragmented union movements, although a general collective agreement and sectoral collective agreements have a strong role in both countries. There is also a strong wage pull from the SOE sector to other sectors, so that one has yet to see the desired level of decentralization in wage setting to develop.

Bargaining Structures in Transition Economies Are Still Evolving, and Their Labor Market Impact Is Underresearched

Overall, the link between wage-bargaining systems and labor market outcomes in the Region remains underresearched, in particular in CIS and SEE countries. With this caveat in mind, several patterns

appear regarding bargaining arrangements and labor market outcomes in the Region:

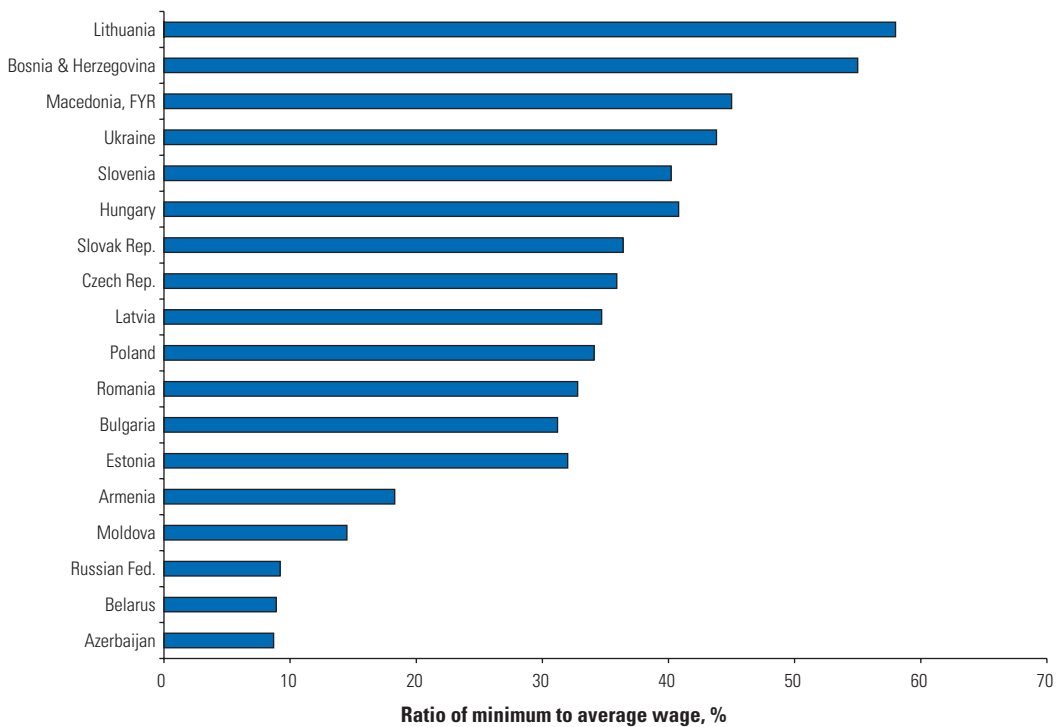
- Changes in union density per se do not have a major impact on employment and unemployment rates, which is consistent with evidence from OECD countries. This is confirmed in multivariate regressions for CEE, Russia, and Ukraine, which control for country characteristics, including the depth of transitional reforms (using the EBRD transition index). The results for (un)employment outcomes also hold for job flow outcomes.²¹ The finding is also confirmed in regression analysis on pooled data for OECD, CEE, and SEE countries for the second half of the nineties.²²
- The typical negative correlation between bargaining coverage and earnings dispersion seen in OECD countries does not appear to hold at the cross-country level in transition economies. The most striking examples of this come from Russia and other CIS countries, which combine high union density rates with very large earning disparities (see chapter 2). However, the conclusion must be interpreted with caution in light of the perhaps misleadingly high density rates from Russia, Ukraine, and other CIS countries. Further research is needed to consider country and subgroup fixed effects.
- State-owned firms (which have higher union density) consistently have a greater share of firm surplus devoted to wages, reflecting insider bargaining power relative to both the privatized and de novo private firms. In the medium term, these firms may lack reinvestment capital; this may lead in time to slower growth and eventually lower employment. This pattern has been found in analyses of Bulgaria, Poland, and Russia.²³
- Evidence from multivariate analysis for CEE, Russia, and Ukraine suggests that both highly centralized or coordinated systems and more decentralized systems are associated with higher employment and lower unemployment.²⁴ In other words, sectoral bargaining tends to deliver the worst employment outcomes, a pattern also observed in the OECD countries.²⁵ Slovenia provides an example of a flexible system whereby firms are allowed to deviate from the minimum wages associated with skills categories to reflect the performance of the firm or individual workers or both. The resulting within-firm wage flexibility appears to reduce excess turnover of workers (that is, improve the stability of employment) and to improve the match quality of workers (that is, improve the degree of adequacy between workers' characteristics and the

requirements of their jobs).²⁶ These findings suggest a microlevel trade-off between wage differentials and employment.

Minimum Wages Vary a Great Deal across the Transition Countries

The minimum wage (MW) is an important element of wage determination. Particularly at the low end of the wage distribution, it may price out low-skilled, often young, workers. Minimum wages in the transition countries exhibit a clear divide between CEE and SEE on the one hand, where they average close to 40 percent of the average wage (AW) in 2002, and the CIS (except Ukraine) on the other hand, where they are only around 20 percent (and for several countries less than 10 percent) of the average wage (see figure 6.2). These ratios place CEE at the high end of the range of minimum wages by international standards and CIS at the low-to-modest end. In Ukraine, where the minimum wage is comparatively high, there is evidence that it is not enforced (see figure 6.3 and World Bank [2005c]). In SEE, both BiH and FYR Macedonia have high minimum-wage-to-average-wage ratios.

FIGURE 6.2
Minimum-Wage-to-Average-Wage Ratio, 2002 (percentage)

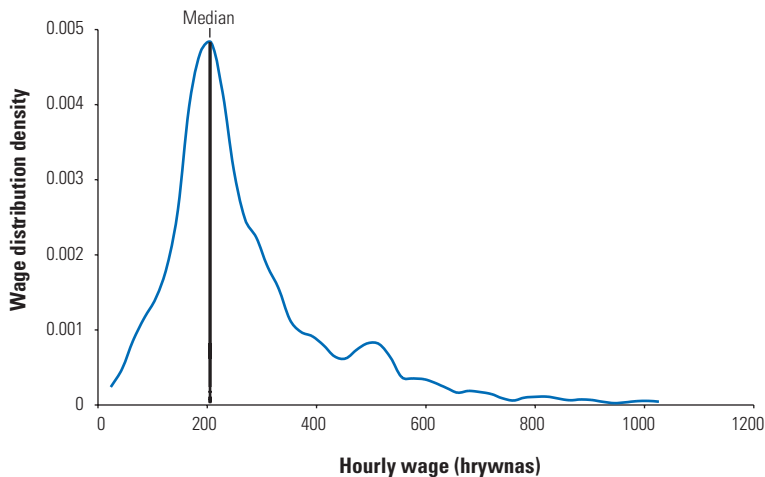


Sources: TransMonee and Bank staff calculations.

Note: BiH = FBiH only.

FIGURE 6.3

Minimum Wage in Ukraine Accounts for a High Percentage of the Market Wage of Low-Skilled Workers, but It Is Not Enforced



Sources: Ukrainian Longitudinal Monitoring Survey, 2004; World Bank 2005c.

Note: The vertical line indicates the minimum wage (205 hryvnas in June 2004). Low-skilled workers are workers classified as “unskilled” according to the ULMS.

Negotiated Minimum Wages Are Often Much Higher Than the Nationwide Minimum Wage

Minimum wages for some sectors are higher—often considerably so—than the national minimum wage. This is typically a product of bargaining at the sectoral level. Examples indicate that the increment of sectoral MWs over general wage floors can be substantial: in Bulgaria, 52 percent of sectoral collective agreements provide for minimum wages higher than the economywide minimum, with negotiated minimums 10–80 percent higher than the national minimum; in the Federation of Bosnia and Herzegovina (FBiH), the minimum wage in the 2004 telecommunications sector collective agreement was double the economywide minimum wage (itself a high 55 percent of the average wage) and equivalent to 110 percent of the economywide average wage.²⁷ Although the principle of varied minimum wages is desirable, the potentially negative employment effects of ratcheting MWs above already high national MWs need to be considered.

Minimum Wages Sometimes Set Social Benefit Minimums

In a number of the transition countries—most notably in Belarus, Russia, Ukraine, and other CIS countries—the role of the official min-

imum wage was perhaps more significant as the base around which certain social benefits were set. Many of these countries have abolished such linkages. Kazakhstan provides a case where this explicit welfare function of the minimum wage has been delinked, with a “base numerator” set instead as the base for determination of certain social transfers.

The Czech Republic, however, provides a good example where such delinkage was done without sufficient consideration for the value of the minimum wage relative to base social welfare benefits, with negative implications for work incentives.²⁸ From 1992 to 1998, various social benefits were linked to the minimum wage. Because of fiscal concerns, the government kept the minimum wage at a low level to avoid increased transfers obligations. However, this was changed in the late 1990s, with the introduction of a “subsistence wage” distinct from the minimum wage, which assumed the function of the benchmark for setting the level of the transfers.²⁹ If low-income workers earn less than this amount, the state tops up their income to the subsistence wage level. With the link to the transfers system, people receive the subsistence wage whether they work or not. Such an example raises the issue of using uniform national minimums in social benefit determination when regional labor markets may have very different market wages on offer. What appears as a reasonable benefits numeraire in the capital city may well have significant work disincentive effects in depressed regions.

Another notable feature of the minimum wage in some countries is its linkage to the revenue system. Croatia and FYR Macedonia constitute an interesting case. These countries do not have any economywide minimum wage as such, but they require that social benefit contributions be paid on the basis of a set minimum amount. Although such an explicit link may be sensible from a public finance perspective, it is questionable whether it is prudent from a labor market perspective.³⁰ In other countries, the relationship to public finances is not explicit, but disproportionately high shares of workers cluster on declared wages at or just above the minimum wage (with evidence of additional undeclared incomes above the minimum), creating incentives to sustain a high minimum wage to sustain tax revenue. For example, in Latvia, almost one-third of private employees earn declared income within 20 percent of the official minimum wage, although the average wage is around three times the minimum and public sector wages exhibit a more regular distribution.³¹ This aspect of minimum wage policy in the Region requires further research.

Minimum Wages Have Stronger Disemployment Effects in Backward Areas and among the Low-Skilled

International evidence shows that high national minimum wages negatively affect employment chances of low-productivity workers, including workers with little labor market experience (for example, the youth), with low skills, and in backward regions (O’Keefe 2004). Large increases in minimum wage levels in the Czech and Slovak Republics (of 70 and 50 percent, respectively—but from very low levels) have led to limited job losses and to large increases in firm wages during 1999–2002.³² However, for specific subgroups of workers, such as the low-skilled or the youth, minimum wages represent a much higher proportion of the reservation wage.³³ For example, in Poland, the minimum wage accounts for more than 80 percent of the wage received by low-skilled workers in high unemployment regions. Because the wage of low-paid workers is close to the minimum, they are the first to be affected by any increase in the minimum wage. Evidence shows that there is a negative relationship between MW/AW ratios and low-paid employment. This suggests that high minimum wages contribute to pricing marginal workers out of the workforce. Some evidence on the negative effects of minimum wage increases on employment rates among unskilled workers is found in regression analyses from Estonia and Hungary.³⁴ It is also consistent with high youth unemployment in the transition countries, particularly given the general absence of separate youth minimum wages (except in Poland).

Employment Protection Legislation Remains Strict despite Reforms, Although Enforcement Is Variable

Employment protection legislation (EPL) is a key labor market institution in ensuring secure and decent work. At the same time, it is important to balance its positive impacts on workers with jobs with the needs of the unemployed and those entering the labor market, whose prospects of being hired may be negatively affected by overly strict job-security provisions. There are also trade-offs from an economic viewpoint between the positive features of strict EPL (such as incentives to provide productivity-enhancing training to workers) and the need for sufficient ease of job turnover to promote efficient allocation of labor and contribute to macrolevel productivity improvements.³⁵ Given the complex balance to be struck in the design and enforcement of EPL, it is perhaps not surprising that

research on its contribution to labor market outcomes, even in OECD countries, has reached contrasting findings.³⁶ Analysis of EPL in the transition countries is further complicated by several factors, including the relatively fast pace of change in EPL during the transition, the unusually high need for labor reallocation, and often weak compliance.

Nearly All Transition Countries Have Liberalized Employment Protection Legislation, Especially Those Moving into the EU

At the beginning of the transition, workers in the Region were among the most protected in the world. This was reflected in the socialist-era EPL, under which dismissals were very difficult, full-time permanent employment was the norm, and workers were entitled to a wide range of workplace benefits and protection. At the same time, protections such as severance pay and notice periods upon dismissal were largely unnecessary (because dismissals were prohibited, except for severe misconduct). Former Yugoslavia, which had very generous provisions on both, was a notable exception.

Nearly all transition countries subsequently carried out significant reforms of EPL, though at varying points during the transition. The direction of initial reforms has been toward greater flexibility in labor relations, including in hiring and firing (for example, lower direct dismissal costs or removal of trade union veto on dismissals), promoting temporary and part-time employment, allowing for opting out of collective agreements, and so forth. Most CEE countries achieved their first wave of EPL reforms early in the transition, while other regions such as SEE and the CIS often delayed reforms until the late 1990s. Many countries have continued to adjust reformed legislation, although in some cases reducing flexibility in later revisions (for example, Romania's second wave of EPL reforms after 1998 and Hungarian reforms effective from 1997).

EU Transition Countries Have Focused More on Liberalizing Temporary Contracts

Although the overall trend in EPL reforms is therefore clearly toward greater flexibility, the progression has not been linear. For 10 transition economies, information has been gathered on the evolution of employment protection legislation since the beginning of the 1990s (figure 6.4). These data suggest that transition economies that were approaching entry into the European Union (for example, Hungary, Poland, and the Slovak Republic) have been more aggressive in liber-

alizing EPL than others whose accession was further in the future (for example, Bulgaria and Romania) or not foreseen in the short term (for example, Ukraine). This suggests that EU accession could have played a disciplining role in promoting reforms.³⁷

It should be stressed, however, that most of the reforms have been concentrated on liberalizing temporary contracts by extending maximum duration of fixed-term contracts or by legalizing temporary work agencies. In other words, following the experience of many continental European countries, EU transition economies have liberalized at the margin, lowering the costs of temporary employment, with more modest reductions in the protection of permanent workers. This may have contributed to the observed duality in the labor market whereby vulnerable groups, including youth, women, and the unskilled, churn from one job to another without being able to build a proper career, while those who maintain a regular contract still enjoy a significant degree of job protection.³⁸

Despite Reforms, Regulations Remain Fairly Restrictive in Most Countries

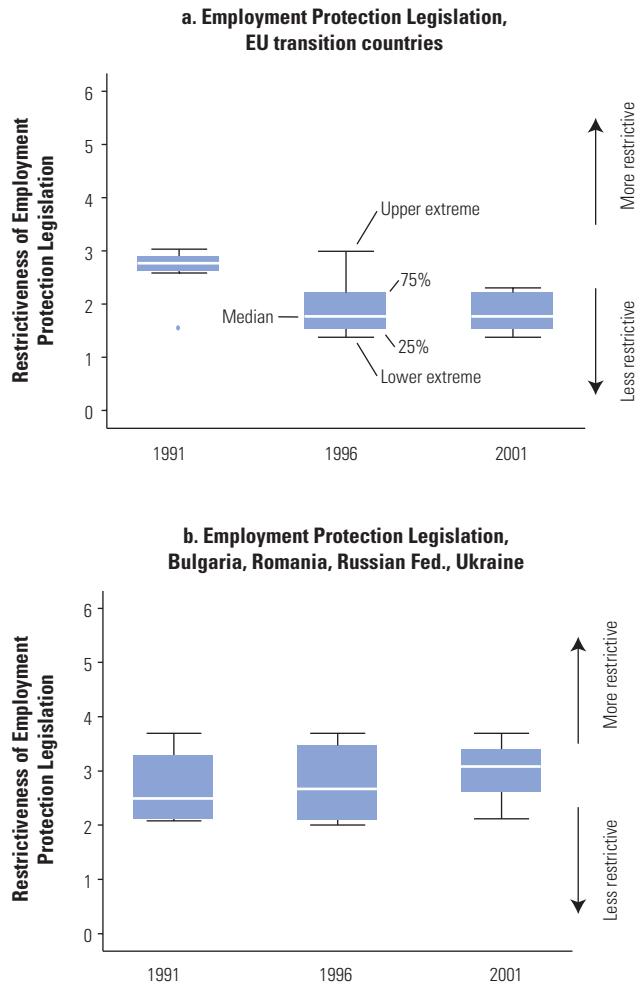
Despite the importance of the many reforms, EPL in the Region remains (on average) stricter than in other regions in the world (figure 6.5). In particular, the stringency of EPL for permanent workers in the Region is (on average) higher than that in any other region except South Asia. However, there is also considerable variation in the Region in the stringency of employment protection, particularly regarding temporary employment (figure 6.6A).

There is no clear subgroup pattern to the relative levels of regular and temporary EPL (figure 6.6B). However, in some cases, the differentials are very pronounced, in both directions. For example, Bosnia and Herzegovina, Bulgaria, and Latvia mainly limit temporary employment and regulate permanent employment less, while Albania, Estonia, Kazakhstan, Poland, and Slovenia provide significantly more protection to permanent employment.

EPL Is Not Fully Enforced in Many of the Transition Countries

There is evidence of weak enforcement of EPL in most of the transition countries, except for CEE.³⁹ This appears to be particularly the case in the CIS and a significant factor in much of SEE. This suggests that the effective rigidity imposed by EPL varies from that indicated by simple comparison of legislation (see also box 5.4). The point is supported by the available evidence on settlement of labor disputes

FIGURE 6.4
Employment Protection Legislation in EU-8 and Other Selected Countries during the Transition



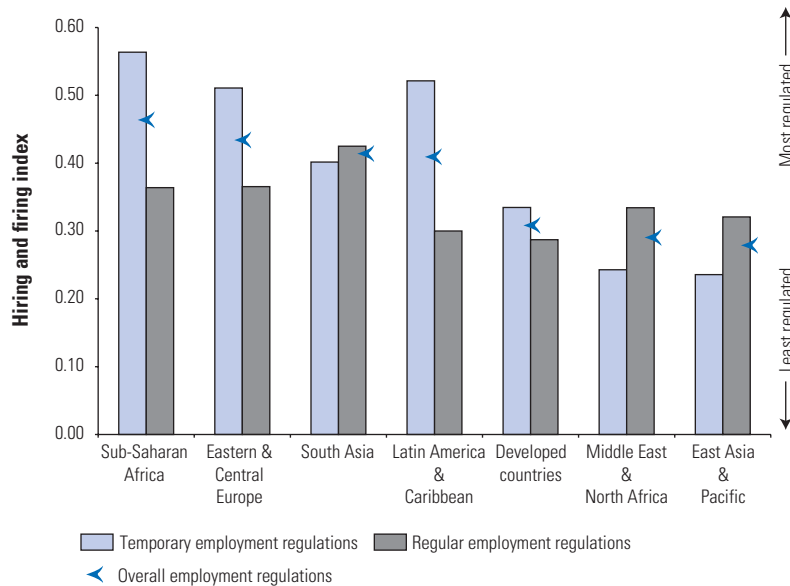
Source: Haltiwanger, Scarpetta, and Vodopivec 2003.

Note: The line in the middle of the shaded box represents the median. The shaded box extends from the 25th percentile to the 75th percentile, the so-called interquartile range (IQR). The lines emerging from the box extend to the upper and lower adjacent values. The former is equal to the 75th percentile plus 1.5 times IQR, while the latter is the 25th percentile minus 1.5 times IQR. Points more extreme than the adjacent values, if any, are outside values and are individually plotted. The employment protection legislation (EPL) index ranges from 0 (the least regulated) to 6 (the most regulated). The index measures regulations for both temporary and permanent employment contracts:

(for example, in Russia) and, for some countries, in the differences between the legislative difficulty of hiring and firing and the ease of both reported by employers (for example, in Romania and Ukraine).⁴⁰ In Belarus, Russia, Ukraine, and other CIS countries, there is widespread evidence of weak enforcement of EPL. It is seen

FIGURE 6.5

Transition Countries Have More-Stringent Regulations on Hiring and Firing than Do OECD Countries

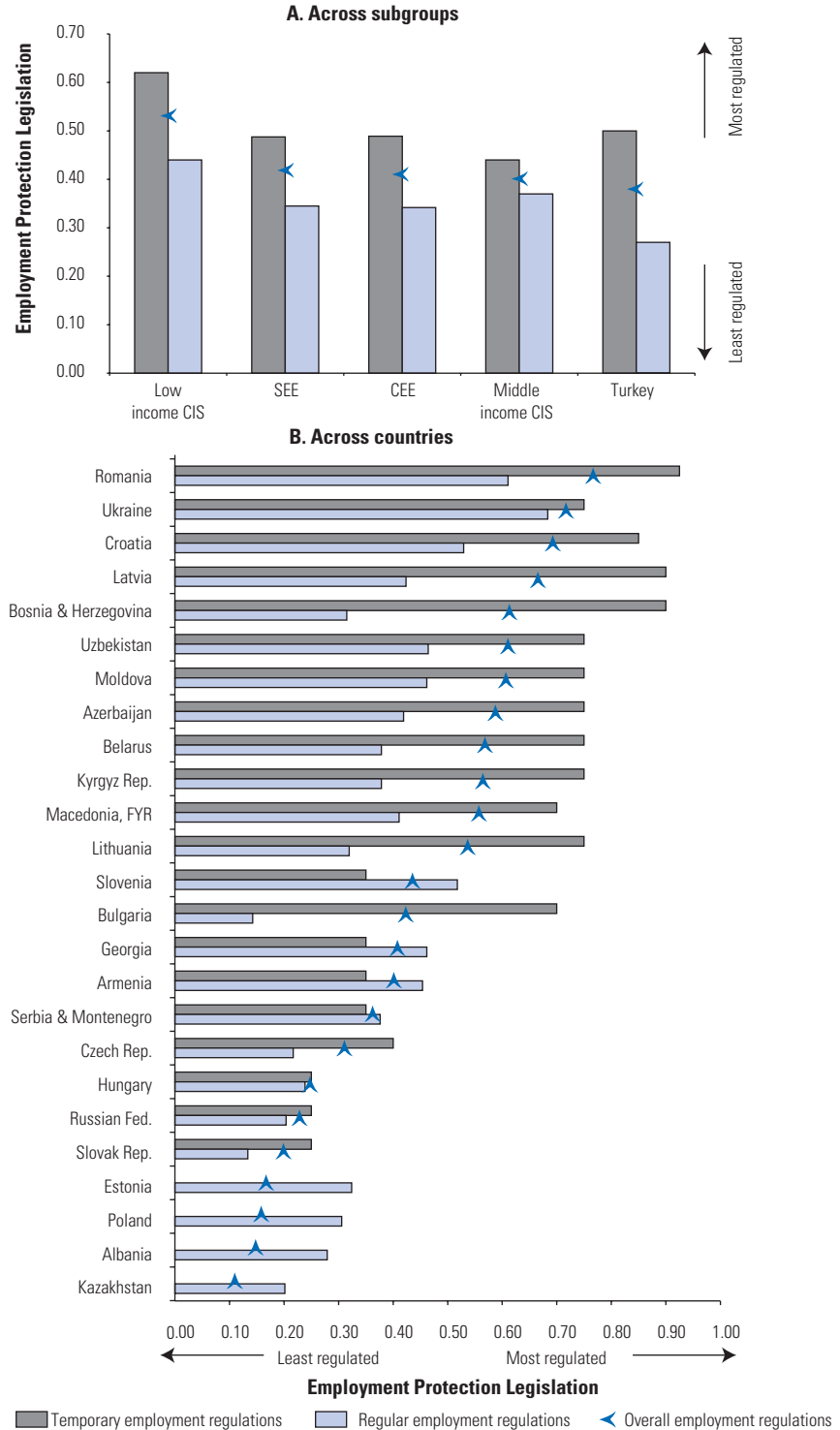


Source: Bank staff calculations based on Doing Business Database (2005). A higher index indicates more-stringent regulations; see annex 6.1 for the construction of the indexes.

most starkly in the massive scale of wage arrears in the subgroups during the 1990s and is supported by employer surveys. For example, in Moldova, despite strict EPL, employers identify labor regulations as their least important problem, which is consistent with the country's high job destruction rate. By contrast, CEE countries have less strict EPL (on average), but are considered more likely to enforce it (for example, evidence from Bulgaria, Lithuania, and Poland indicates that the costs of court challenges to dismissals act as additional disincentives to firing workers). Finally, there is evidence (for example, from Lithuania and Poland) that EPL is more strongly enforced in large firms, which typically have a stronger union presence.

Table 6.1 shows a tentative characterization of the transition countries according to the strictness of EPL and its enforcement. It is indicative only, but illustrates that the effective impact of strict EPL in the Region may be less than comparisons of labor legislation would suggest, with only Slovenia having both strict EPL and strict enforcement. Although the characterization is crude, it indicates that countries in the top right of the table need to focus more on credibly enforceable laws as opposed to "paper protections," which at best protect a limited share of formal sector workers.

FIGURE 6.6
There Are Significant Differences within the Region's Countries on EPL



Source: Bank staff calculations based on Doing Business Database (2005).

TABLE 6.1

EPL and Enforcement Typology

	Flexible EPL	More restrictive EPL	Very rigid EPL
Weaker enforcement	Albania, Kazakhstan	Armenia, Georgia, Russian Federation, Serbia and Montenegro, Turkey	Azerbaijan, Belarus, Bosnia and Herzegovina, Kyrgyz Republic, Moldova, Ukraine, Uzbekistan
Intermediate enforcement		Bulgaria	Croatia; Macedonia, FYR; Romania
Stronger enforcement	Czech Republic, Estonia, Hungary, Poland, Slovak Republic	Latvia, Lithuania, Slovenia	

Source: Bank staff calculations.

Note: (i) Strictness defined as whether country EPL index below world average EPL index in Doing Business 2005, up to 20% higher and more than 20% higher; (ii) strength of enforcement based on share of informal sector employment. The degree of enforcement is proxied by the size of the informal economy; the higher the informal economy the weaker the estimated degree of enforcement (Schneider and Klinglmaier 2004, and country studies where available). For Russia the EPL index was corrected toward stricter EPL following comments from Russian experts.

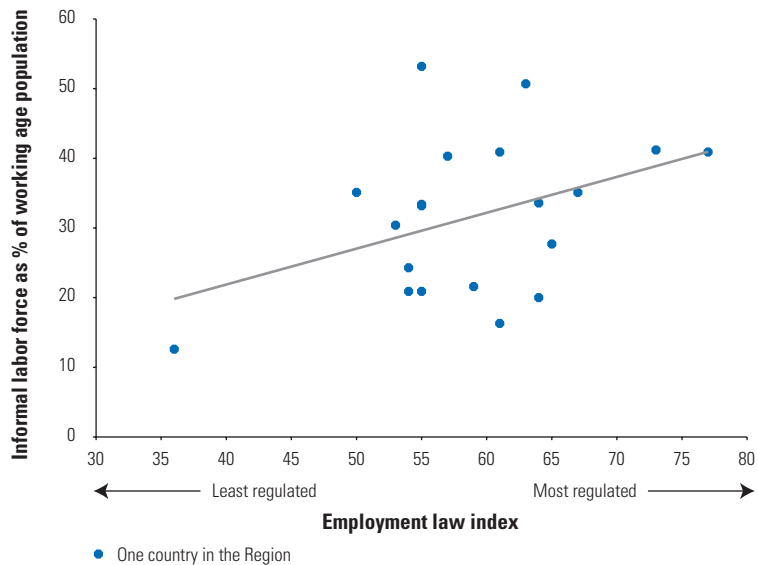
Even with Varying Enforcement, Strict EPL Has Had Some Negative Impacts on the Labor Market

Despite varying enforcement, available analysis indicates that there remain costs from strict EPL in the Region. First, strict EPL may promote informality, self-employment, and small firms (which often fall outside EPL). The positive correlation between strict EPL and the share of informal sector employment can be seen in figure 6.7. A similar positive association holds between the strictness of EPL and the share of self-employment.⁴¹ Given that informal employment is frequently low-productivity, strict EPL can hamper productivity growth.

Second, strict EPL gives rise to less favorable employment outcomes in transition economies. The relationship between EPL and employment outcomes is difficult to identify statistically. One reason is that the system is still moving toward equilibrium, and thus the steady state (un)employment rate is not known. For example, cross-country regressions for the late 1990s suggest insignificant correlation between EPL and aggregate unemployment in countries from OECD, CEE, and SEE (Cazes and Nesperova 2003; Micevska 2004), although they find that stricter EPL increases the risk of long-term unemployment. However, these static studies do not capture the effects of the significant institutional changes that transition countries carried out over the 1990s, nor do they use a steady state unemployment rate as a dependent variable.

In contrast, more complex, cross-country, pooled regression analysis (which adds the time dimension to the relationship) finds negative

FIGURE 6.7

Informality Tends to Be Higher in Countries with Strict EPL

Sources: Doing Business in 2004 for EPL; Schneider (2002) for the size of the informal sector.

effects of strict EPL for CEE, Russia, and Ukraine.⁴² In countries with low coordination among partners in wage bargaining,⁴³ strict EPL is found to weaken labor market outcomes, but in countries with a high degree of coordination, the effect is less marked. Significantly, the effects of EPL on employment rates are weaker in the Region than in OECD economies, while they are stronger for unemployment rates. This is consistent with strict EPL being unable to prevent job destruction, but still contributing to less formal sector job creation. It is also consistent with employer surveys, in which firms that are expanding are more likely to report EPL as a major obstacle in their operations, while nonexpanding firms are less likely to do so.

In addition, greater job security for those with jobs appears to come at a cost for the unemployed and new entrants in the labor market, so that (re)entry into formal sector employment is negatively affected. This “insider-outsider” impact on formal sector employment rates would appear to undermine the claim that strict EPL is “always good for workers” in the aggregate. Moreover, evidence from the Region indicates that reforms of EPL have not been associated with higher income inequality and that there are, if anything, higher income disparities in countries with stricter—but weakly enforced—EPL.⁴⁴

A further important finding of regression analysis is that EPL has a significant association with the pace of labor reallocation. For CEE,

Russia, and Ukraine, regression analysis reveals that a more-stringent EPL is associated with lower job creation, lower job destruction, and thus lower job reallocation.⁴⁵ This in turn is likely to feed through to impacts on productivity. These findings are consistent with more-detailed country case studies (for example, in Croatia, Bosnia and Herzegovina, and the Slovak Republic). This supports the intuition that strict EPL dampens job flows, even with weak enforcement. Empirical findings on employers' perceptions of the impact of EPL also suggest that firms that are in the process of upgrading or developing new product lines and potentially need additional skilled workers are more affected by strict EPL than others (see chapter 5).

Finally, regression analysis on pooled data from OECD, CEE, and SEE countries for the second half of the 1990s finds that strict EPL influences the composition of unemployment: the strictness of temporary EPL provisions is positively correlated with higher youth and female unemployment, stricter EPL increases the risks of long-term unemployment, and stricter temporary EPL discourages labor supply.⁴⁶

Taxes on Labor

Taxes on labor may impact equilibrium wages; this in turn may affect equilibrium employment. The extent of the employment impact is affected by the level of competition in the labor market. In particular, the impact of high taxes on labor use depends on the extent to which there is "tax shifting" of labor taxation onto the cost of labor (and hence labor demand), as opposed to shifting it onto take-home pay (and hence labor supply).

High Taxes on Labor Use, Especially in CEE Countries

The tax wedge on labor in the transition countries is high—in many cases, very high. At the same time, like most labor market institutions, it exhibits considerable variation across countries, both in aggregate level and composition (figure 6.8). Overall, the tax wedge on labor in CEE and Turkey is very high by any standard, while labor taxation in CIS countries is lower (on average). The tax burden on labor is at an intermediate level in SEE countries, but remains high by international standards.⁴⁷ On average, the tax wedge on labor in Belarus, Russia, Ukraine, and other CIS countries is more than 14 percentage points lower than that in CEE and Turkey, while for SEE, it averages around 11 percentage points lower than that in CEE and

Turkey (figure 6.9). The differences in payroll and effective personal income tax rates are likely to be amplified in practice by variable tax enforcement capacity across the Region.

For CEE, the comparison with OECD countries is of interest (figure 6.9).⁴⁸ The regional average tax wedge is around 8 percent lower than the OECD average (excluding CEE OECD countries). However, the averages mask considerable variety in both groupings. The tax wedge on labor in CEE countries is noticeably higher than the OECD average.⁴⁹ Once OECD countries are disaggregated into high, medium, and low labor tax wedge groups, CEE averages are 10 per-

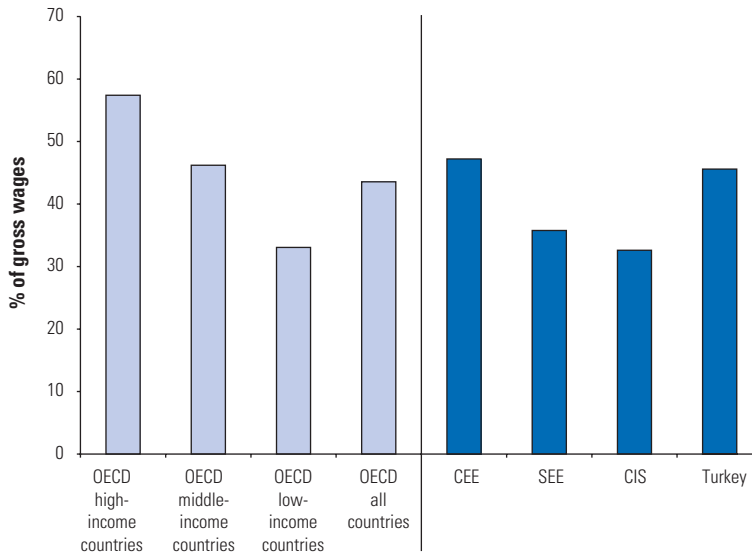
FIGURE 6.8
The Region's Tax Wedge on Labor, 2003



Sources: OECD (2004b) for Czech Republic, Hungary, Poland, and Turkey; Bank staff estimates for other countries.

Note: Tax wedge for nonagricultural worker on average wage without dependents.

FIGURE 6.9

Tax Wedge on Labor, the Region, and OECD, Early 2000s

Sources: OECD (2004b) for OECD and CEE OECD, except Slovenia (based on 2001); Bank staff estimates for others (using 2003).

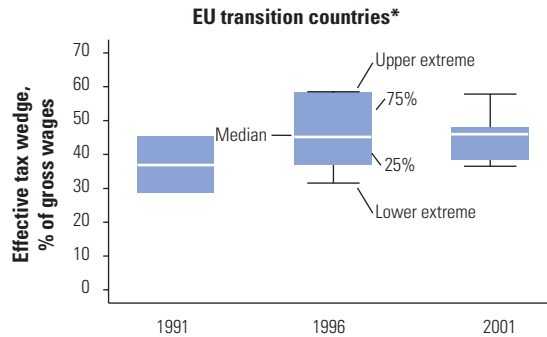
Note: Tax wedge calculated for nonagricultural AW worker without dependents in the Region and production AW worker without dependents in OECD. OECD groupings exclude CEE OECD: (i) low (less than 40% wedge) includes Australia, Iceland, Ireland, Japan, Korea, Mexico, New Zealand, Portugal, Switzerland, UK and USA; (ii) mid (40-50%) includes Canada, Denmark, Greece, Luxembourg, Norway, Spain and Sweden; (iii) high (51+ %) includes Austria, Belgium, Finland, France, Germany, Italy and Netherlands.

centage points lower than the average for the OECD group with the highest average tax wedge. Hungary is the only country of the Region that would fit firmly within the high labor tax OECD group. In contrast, CIS has an average tax wedge on labor equal to the average for the low-labor-tax OECD group, which includes Korea and Mexico, which are the only OECD members with comparable income levels. The SEE average is between the low- and medium-labor-tax OECD groups and somewhat below the overall OECD average.

For six CEE countries, there is also information on the evolution of the tax wedge during the 1990s (figure 6.10). Contrary to the patterns of employment protection and the decline in the generosity of unemployment benefits (see below), the tax wedge has increased (on average) in these countries, with a reduction in the cross-country dispersion of tax wedge rates. The surge in other social expenditures, predominantly pensions, has led to further increases in the fiscal burden on the use of labor. In this context, it is not surprising that many employers in the Region found the tax burden to be one of the most serious constraints to operating their firms (see chapter 5).

Although the high tax wedge in the Region is important, there is also considerable evidence—particularly in the earlier part of the

FIGURE 6.10

Surge in the Tax Wedge in EU Transition Countries during the 1990s

Source: Haltiwanger, Scarpetta, and Vodopivec 2003.

Note: See note to figure 6.4 for details on the construction of the graph. The tax wedge on labor use is the ratio of total taxes—income taxes and social security contributions—over wages plus employers' social security contributions. The *effective* tax wedge is based on tax, social security receipts and the wage bill, as opposed to the *notional* tax wedge which is based on average tax and social security rates for the average production worker.

transition, and before reforms of tax administration in a number of countries—of partial tax compliance, particularly in low-income countries and those affected by conflict. The combination of high taxes on labor and the low capacity of the public sector to enforce compliance points to ambiguous effects on aggregate (un)employment. However, the relatively stronger enforcement capacity of CEE countries, combined with their very high labor taxation, could raise labor costs and affect employment. This is true at least for countries with low-productivity potentials whose wages cannot fully compensate for the high taxes because of minimum-wage rules.

High Taxes on Labor Use Are Associated with Negative Labor Market Outcomes

Evidence from OECD countries suggests that the pass-through of taxes onto wages depends on wage-bargaining systems.⁵⁰ In countries with sectoral wage bargaining, where there is a lack of coordination between social partners, the pass-through onto wages is more limited because workers have fewer incentives to consider the effect of their bargaining on employment. In such countries, labor taxes are therefore found to have greater negative effects on labor market outcomes. Similar effects may be at work in the transition countries.

What are the findings on the impact of labor taxation on labor market outcomes in the Region? Available cross-section and panel regression analyses on the impact of taxes on labor in the Region, although limited, find impacts similar to those in OECD countries.⁵¹

This is reinforced by information on employer perceptions reported in chapter 5, identifying high taxes as a major constraint on firm operations. The high tax wedge on labor, especially in CEE, is associated with lower employment rates, higher unemployment rates, higher long-term unemployment rates, and higher youth unemployment rates.

It is clear that to foster job creation in the longer term, a number of countries in the Region need to consider significant reductions in their tax burden on labor. A challenge facing the transition countries is the need for a reduction in payroll taxes from a labor demand viewpoint amid social expectations of maintaining social insurance systems at current levels. This raises important reform issues in pensions and health insurance. Given demographic trends, further reforms of social insurance programs will be needed simply to avoid substantial increases in payroll taxes across the Region.

The Role of Passive and Active Labor Market Programs

High and persistent unemployment in many transition economies creates political demand for the use of passive and active labor policies. The case is reinforced by equity arguments, given the significantly higher-than-average poverty rates among households with unemployed heads in the transition countries (for European transition economies, mean expenditures of unemployed-head households is only 68 percent of the average, but in the CIS around 85 percent) and by political economy arguments at a time when significant reforms are necessary and public acceptance is crucial. However, because of poor incentive effects and moral hazard, passive labor market policies may create economic inefficiencies and entail large government expenditures. Active labor market programs (ALMPs) may also be very costly, and their success in helping the unemployed needs to be evaluated to justify such spending.

The developments in both passive and active programs for the unemployed have been rapid in the Region and have included major adjustments in many countries during transition. These interventions are a crucial part of the menu of policies that governments can use to help displaced workers and other disadvantaged groups find new jobs. This section draws from available empirical evidence to outline which types of policies and designs have been more successful. It argues that if there is adequate administrative capacity, ALMPs can be used to help disadvantaged worker groups and improve the matching function of the labor market. But they hardly increase aggregate

employment. ALMPs are costly, and thus monitoring and evaluation are necessary to ensure that they have the net impact (for example, significantly improving the job-finding chances of program participants) that justifies the cost. The level of spending and the mix of programs will depend on what individual countries can afford in their financial and administrative capacity.

All Transition Economies Introduced OECD-Style Unemployment Insurance, and They Have Reduced Their Generosity to Contain Expenditures

The need for major reallocations of labor during transition led to the introduction of unemployment insurance systems in all transition countries by the early 1990s. They adopted OECD-type mandatory unemployment insurance (UI) schemes, financed in nearly all cases from payroll taxes, with some CEE countries introducing unemployment assistance following expiration of unemployment benefits (UB).

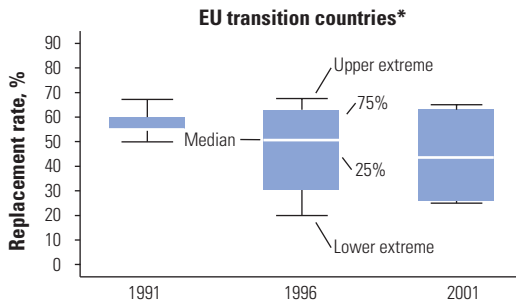
As in the OECD, unemployment benefits in the Region are typically earnings-related, though subject to floors and ceilings. In recent years, the range in replacement rates for UI has been 35–60 percent of the previous wage. This is equivalent to 60–100 percent of the national minimum wage and 10–45 percent of the national average wage in CEE. The effective replacement rate in some countries was also considerably below the legislated rate because of payment arrears (for example, in Russia, the low income CIS countries, and Serbia and Montenegro) and benefit ceilings (for example, Croatia).

The replacement rate has been adjusted downward in a number of CEE, SEE, and CIS countries during the 1990s in the face of fiscal constraints and significant flows into unemployment. It had reached an average of just more than 40 percent of the average wage by the end of the decade in EU transition countries (figure 6.11). The decline has, however, been accompanied by a widening of the replacement rates across these countries, with some (for example, Poland) moving to a flat level and others maintaining the earnings-related system.

Although replacement rates are broadly comparable to EU and OECD averages, it is important to note the significant variation in rates across countries and the implications of the typical practice in the Region of designing programs with benefit floors related to national benchmarks. This can result in replacement rates relative to average wages in depressed regions that can be very high, risking employment disincentives. This issue is a concern in CEE, in particular.

FIGURE 6.11

Unemployment Benefit Replacement Rates Have Declined in EU Transition Countries during the 1990s



Source: Haltiwanger, Scarpetta, and Vodopivec 2003.

Note: See note to figure 6.4 for details on the construction of the graph. The replacement rate is the ratio of unemployment benefits over previous wage. It refers to a worker earning an average wage while at work and with sufficient work experience to claim benefits for the maximum duration.

Benefits duration in the transition countries falls within a range comparable to that in OECD countries—between six months and a year at the end of the 1990s. In some SEE countries, unemployment benefits duration reaches 24 months. Across the Region, there was a convergence in benefits duration during the 1990s, with a number of countries reducing high benefits duration in response to fiscal pressures and a growing pool of long-term unemployed.

Coverage Is Low, Especially in the CIS

Coverage rates of UI programs (that is, the share of the registered unemployed receiving unemployment benefits) vary between countries and over time. This is in part related to the varying treatment of noncontributing groups like school leavers and other special groups and to the extension of UI duration for older unemployed. It also reflects the growing pool of unemployed who have exhausted their benefits entitlement. On average, the share of registered unemployed receiving benefits is just under 30 percent in the Region, and it has been falling over time in most countries. In CEE, the average coverage rate was around 45 percent at the end of the 1990s, while for SEE the coverage was much lower, at around 12 percent, largely reflecting tighter qualification rules.

Overall, the combination of coverage and replacement rates and benefits duration means that UI systems in CEE and SEE are at the lower end of OECD generosity and well below such levels in the CIS. The very low generosity of the CIS systems has made UI systems

increasingly irrelevant, contributing to low registered unemployment rates. The level of generosity is also reflected in spending shares on unemployment benefits, which in the late 1990s ran to an average of around 0.7 percent of GDP in CEE and SEE, but only 0.1–0.3 percent of GDP in the CIS. This compares with OECD and non-Region EU averages of around 1.4 and 1.7 percent, respectively.⁵²

Two other considerations are important concerning UI in the transition countries:

- In a number of countries, a range of noncash benefits attached to registered unemployment status may have a strong impact on incentives to register. The most significant is free health insurance. There is evidence that in countries of former Yugoslavia, as well as in Poland, workers register as unemployed to ensure family health insurance coverage when no one in the household is paying social contributions. In Bosnia and Herzegovina, for example, only 25 percent of registered unemployed were actually unemployed, according to ILO definitions.⁵³ In Croatia, this proportion is still higher and was 40 percent in 2001. This contributes to substantially inflated official unemployment figures in some countries. Conversely, the effective absence of additional entitlements for registered unemployed in the CIS reinforces low incentives to register. Also in Russia and other CIS countries, the services provided by public employment agencies do not provide better alternatives than individual job search, so the payoff to registering is negligible.
- As suggested above, the stringency of work test enforcement varies substantially across the Region. Country studies, such as one for the Czech Republic, indicate that the stringency of work test enforcement has been a contributing factor to keeping registered unemployment rates low. In contrast, most countries in SEE and the CIS make minimal efforts to enforce work tests, in part because of low labor demand and in part because of low administrative capacity. However, in Russia, administrative restrictions often lead the long-term unemployed to be struck from the register.

More Generous UI Systems Have Been Associated with Poor Employment Outcomes

Multivariate analysis for CEE, Russia, and Ukraine suggests that, if too generous, unemployment benefits might have a negative impact on labor market outcomes, with the level of benefits negatively affecting employment rates, and duration of benefits being strongly associ-

ated with a higher unemployment rate, and especially a higher long-term unemployment rate.⁵⁴ This is consistent with OECD findings, but both the level and duration effects are stronger in transition than in OECD economies. In addition to these aggregate findings, studies of exits from unemployment in CEE confirm the negative effects of potential benefits duration on the probability of exit from unemployment to employment, with notable increases in exits to employment near benefits exhaustion.⁵⁵

The findings support the point made above that the generosity of CEE unemployment insurance systems in the initial stages of transition acted as a floor on real wages, inducing lower exits from unemployment by raising the effective reservation wage. However, it is also important to note that subsequent tightening of UI through duration and level reductions had only a moderate impact on exits from unemployment to employment.⁵⁶ The explanations include weak labor demand, structural mismatches and informational failures associated with geographic and sectoral segmentation, and inherited attitudes of the unemployed toward the role of the state in providing employment.

Social Assistance Programs to Help the Long-Term Unemployed and the Poor

Social assistance systems may be important in terms not only of poverty alleviation but also of labor market adjustment. To the extent that they work effectively, they help to protect workers who have lost their jobs and exhausted other entitlements before finding new work. However, there is also a risk that, if not well-designed, they raise the reservation wage above market wages, thereby discouraging job search. In contrast, where social assistance systems provide negligible benefits, workers are more inclined to remain in poorly paid jobs, willing to tolerate extended wage arrears and periods of administrative leave. A well-designed and adequately financed social assistance system can therefore have a role to play in labor adjustment—both in ensuring adequate work incentives and in encouraging productivity-enhancing labor turnover.

The mix of social assistance–welfare programs within and between transition countries is complex. Apart from means-tested social assistance, there are typically child-family benefits; often benefits for utilities for poor households; in-kind benefits; and benefits for specific groups such as refugees, veterans, and survivor families. Although all countries in the Region introduced an OECD-style mix of social protection programs, the generosity and credibility of the systems have varied dramatically across the Region.⁵⁷

Over the transition period, the evolution of basic social assistance programs has been varied. Some countries have remained with the initial mix of programs, while others have been more innovative in experimenting with minimum income guarantees (for example, Estonia and the Kyrgyz Republic) and benefits structured as negative income taxes (for example, Lithuania).⁵⁸ Others, such as Armenia and some oblasts of Russia (as well as Turkey), have introduced proxy means-tested programs for the poor. Others still, including Albania and Uzbekistan, have relied on community knowledge to target poor households. Moreover, following the experience of other developing countries, some economies of the Region have introduced programs that provide income support to poor families conditional on either basic needs triggers or behavioral changes (box 6.3).

The variations in the type and coverage of social assistance programs are in part a reflection of varying fiscal constraints and adminis-

BOX 6.3

Innovative Ways of Targeting the Poor

Two innovative ways of targeting the poor have gained momentum in developing countries and have been tested in some countries in the Region in recent years.

Conditional cash transfers are an innovative channel for the delivery of social services that is being implemented in an increasing number of countries.^a They combine close targeting with capital accumulation by making income support conditional on either basic needs triggers or behavioral changes. Conditional cash transfers have virtually not been used in the Region so far, but they have been successfully implemented in Turkey, where there is evidence that they are resulting in higher attendance rates and higher continuation rates from primary to secondary education.

Social funds are investment funds that implement a bottom-up model in which communities and local institutions, rather than central governments, take the lead in identifying and carrying out community-level investments. The Armenia Social Investment Fund, created in 1996, was the first in the Region. A recent review of such funds in six developing countries, including Armenia, suggests that they are relatively successful. In Armenia, investments in education (school buildings, furniture, and basic equipment) are found to have increased primary enrollment rates, and investments in water and sanitation have decreased the frequency of illness in children.^b

a. See Rawlings 2004.

b. See Rawlings, Sherburne-Benz, and Van Domelen 2004.

trative capacity, both between and within countries. Overall, there is a major gap between spending as a share of GDP on nonemployment programs in CEE, SEE, and the CIS. For example, during 1991–95, nonemployment benefits ranged from 1.6 percent of GDP in Bulgaria to 5 percent of GDP in Poland in CEE countries, while they represented only 0.3 percent in Ukraine and 0.6 percent in Russia.⁵⁹

Social Assistance Benefits Are Linked to Minimum Wage or Other Social Minimums

An important factor in a number of countries is the connection between the minimum wages and social benefits. This may in some cases create work disincentives, as well as overburdening the minimum-wage-setting process. As shown above, the Czech Republic during the 1990s provides an example of both these effects.

A further factor about social welfare benefits and labor market outcomes relates to program incentives to (re)enter the workforce for those able to work. There has typically been limited effort to encourage this in transition economies, either through workfare or incentives in the benefits themselves. Bulgaria is an exception, with its “From Social Assistance Toward Employment” program, under which social assistance recipients (with a priority for long-term unemployed) must accept temporary work or risk a reduction or removal of benefits. The participants also receive pension and health insurance. Participation can be no more than three years. This has led to significant reductions in social assistance rolls (see box 6.4);⁶⁰ however, the longer-term impact of such programs is less clear. For example, no positive impact on employment was found in a follow-up study of a similar regime introduced in Hungary in 2000 (Galasi and Nagy 2003).

The Generosity of Social Assistance Is Associated with Wage and Labor Turnover Outcomes

Overall, the labor market impacts of social assistance programs are not well researched in the Region. However, some evidence from CEE indicates that social welfare benefits spending facilitated restructuring in the face of falling real wages.⁶¹ By 1997, in CEE countries, there were more unemployed people on means-tested social assistance than on unemployment benefits.⁶² By contrast, in the CIS and most of SEE, lower spending on social welfare benefits, combined with the less progressive incidence of most social transfer spending, meant that workers were willing to tolerate much greater falls in real

BOX 6.4**Public Works and Workfare: An Alternative to the Unemployment Benefit?**

Temporary relief work or public works have been used extensively in many transition countries. Normally, they may be a short-term bridge between more-permanent jobs, especially in environments where jobs are few. They are designed to require high effort and low pay to ensure that only the neediest take part. The length of these jobs can vary, but typically it is between three months to one year. The long-term employment impact of these programs is often insignificant, and the unit costs are high. The organization of public works is often complicated because of a mismatch between the skills needed by employers and the qualifications possessed by the unemployed. Many transition countries have used an offer to take part in public works programs as a work test or a disciplinary measure, to disqualify individuals who may have had hidden employment or income from temporary income support programs. Experience showed that programs operated by private sector employers resulted in more positive impacts than when they were implemented by public agencies.

Public works were initially invented to address demand deficiency unemployment; however, they have increasingly turned into income-support programs largely targeted at low-skilled, long-term unemployed and other disadvantaged groups (for example, older workers and those in distressed regions). This role has developed particularly in those countries where work incentives faced by the unemployed are weak because of benefits being close to the expected market wage. The underlying concept, known as workfare, is that able-bodied individuals should receive income support conditional upon, or in return for, performing some publicly useful work, to self-target the poor.

For example, workfare was introduced in Albania, Bulgaria, and FYR Macedonia. However, in Albania and FYR Macedonia, wages were not set low enough to attract only the poorest workers.

wages without exiting their (generally public sector) jobs. The relatively weaker role of social welfare benefits is also found to have contributed to the higher income inequality that emerged in Belarus, Russia, Ukraine, and other countries of the CIS over the transition period relative to CEE.⁶³

Active Programs Have Been Introduced to Strengthen the Matching Process in the Labor Market

All transition countries developed active labor market programs (ALMPs) to support workers affected by labor mobility. The programs include job counseling or job search assistance or both, wage subsidies, training and retraining programs, public works, and self-

Because of considerable income from the informal sector, people in FYR Macedonia did not wish to join public works programs even though the benefit was set at the average wage. In Albania, a community job creation program to undertake public services and infrastructure projects within the community (for example, village roads, water drains, and so forth) was piloted in the late 1990s through the Bank Labor Market Development Project and then implemented on a broader scale by the National Employment Service through government funds. Recipients of social assistance had to “delegate” one household member to take part in the program. Because wages earned were significantly higher than social assistance received, there was a significant demand for those jobs.

A similar program in Bulgaria, “From Social Assistance Towards Employment,” in which the unemployed individuals—recipients of social assistance—are given an option to either accept temporary jobs or else risk their social assistance benefit being cut or reduced, has been more successful. Wages are set at the minimum wage level, but those employed have to give up their social assistance benefits. Among the reasons for the attractiveness of the program might be that the participants are also covered with pension and health insurance (including maternity benefits). Also, for some of the participants from ethnically mixed regions, employment is combined with literacy enhancement and vocational training.

In summary, if well designed and carefully targeted at disadvantaged worker groups, public works and workfare programs can provide income support to the unemployed without causing adverse labor supply incentives. Public works can also be effective when the intention is well defined (for example, to improve local infrastructure) and are arranged in close collaboration with local authorities (for example, with cofinancing arrangements). Design features that contribute to the success of workfare schemes also include (a) organization by private employers and (b) wages set below the market level to ensure self-targeting by the neediest among the unemployed and to prevent participation in public works becoming an attractive alternative to permanent employment.

employment support. The relative emphasis of different types of ALMPs has varied considerably between countries.

Public expenditures on ALMPs in transition countries have been considerably lower than OECD and EU averages as a share of GDP, with CEE average spending in the late 1990s around 0.4 percent of GDP and SEE only around 0.1 percent of GDP. This compares with an EU-15 average of 1.2 percent and an OECD average of 0.9 percent of GDP. However, there is also considerable variation between CEE countries in the share of spending on ALMPs, with the CEE average concealing a number of countries with spending shares on ALMPs well below the lowest OECD countries. In the CIS countries, spending on ALMPs has been a negligible share of GDP, and they cannot be considered a significant policy in most of the subgroup.

Although Not Increasing Aggregate Employment, ALMPs Have Had Positive Impacts When Supportive Preconditions Prevail

The available evaluations in the Region suggest that ALMPs can improve the labor market outcomes of target participants,⁶⁴ but only when some facilitating preconditions are met. It is important to stress that ALMPs achieve far less when labor demand is depressed and when the investment climate is poor. They are not a substitute for job creation by private firms. Even in conducive circumstances, they are only part of a menu of policies to support employment growth. Although ALMPs in the Region have in several cases improved the matching function of the labor market, they are only a supplemental tool for improving labor market outcomes, the effectiveness of which is largely dependent on employment-enhancing policies outside the labor market itself. Nonetheless, while ALMPs may not raise aggregate employment, redistributing job opportunities toward the disadvantaged worker groups may have more than typical value in the Region because of the larger stagnant pool of long-term unemployed.

Some ALMPs Have Proven More Effective Than Others

Evaluations of ALMPs in the Region are from CEE and some SEE countries only and are relatively few to date. In some cases, the employment impact of programs in the transition countries has been more positive than OECD comparators. This is most notable with training. Overall, however, they indicate that the net impact of ALMPs in the Region seldom exceeds 10 percent and is often lower.⁶⁵ Certain ALMPs work better and are more cost-effective than others, with the ranking of interventions varying according to specific labor market conditions and dependent on the effectiveness of local institutions. Questions remain on their relevance for the poorer and more informal economies in the Region, where informal networks may play a stronger role in finding employment. Although the effectiveness of specific programs in specific countries cannot be determined beforehand, some findings emerge from evaluations in the Region:⁶⁶

- Multivariate regression analysis from CEE in the 1990s found significant positive effects of ALMPs on outflows to jobs among the unemployed in Bulgaria, the Czech Republic, Poland, and the Slovak Republic, while in Hungary the impact was never significant.⁶⁷
- As in other regions, job search assistance in this Region—generally provided by public employment services—has proved the most

cost-effective intervention to address the structural component of unemployment. The positive effects in reducing unemployment duration appear to be clearer in transition countries than in OECD countries.⁶⁸

- The employment impact of training seems positive and notably better than that for the OECD, though the impact on earnings has been mixed. Training programs in the Region also appear to have been more cost-effective. Targeted small-scale programs focused on specific groups have tended to have a positive net impact, particularly for the low-skilled. For example, in Hungary and Poland, the net impact of training on workers with primary education was found to be 15–17 percent, while in Bulgaria it exceeded 20 percent. The available evaluations confirm a significant employment effect for the poorer and more informal economies in SEE. As noted above, net impact evaluations have not been carried out in the CIS.
- The evidence on the impact of wage subsidies is mixed. In some countries (for example, the Czech Republic and Hungary), they have proven effective in helping disadvantaged unemployed, with a net postprogram impact ranging from 10 to 15 percent. The effects have been particularly positive in high-unemployment regions in countries such as Bulgaria. The results are more positive than evaluations of similar programs in OECD countries. However, some evaluations also show negative employment effects of wage subsidies.
- Public works can act as effective safety net interventions, but the impact on the employment prospects of participants has been mixed. In general, the transition countries have relied on public works far less in their mix of ALMPs than both a number of OECD countries and other regions such as South Asia have. Outcomes range from significant negative impacts on future employment prospects and wages in Hungary and Poland, to no impact in Romania, to positive—though perhaps short-term—employment impacts in FYR Macedonia, the Slovak Republic, Slovenia, and Ukraine. However, it is important to view public works more as an income-support program than as a typical ALMP, so the temporary income impact on participants should probably be given higher weight than for other types of programs (see box 6.4).
- Programs that promote self-employment—typically credit or grant programs, often combined with business advisory services—have been less evaluated in the Region. The available evaluations indi-

cate positive outcomes from such programs, but the results are limited because they target a small subgroup of the unemployed.

An important consideration in interpreting the above results is the institutional capacity of public employment agencies. There has traditionally been a tendency in the Region for employment agencies that operate both UI and ALMPs to run their own programs. In a number of cases, private employment agencies have been prohibited under the relevant legislation (although this is generally being remedied now). The public provision of ALMPs has in many countries resulted in programs that take limited account of local labor demand in their design. A further concern in some countries has been the governance of unemployment funds; for example, such funds may be used for political or other purposes, or there may be a lack of transparency, making it difficult to track the use of the funds. Finally, the design and evaluation of such programs are important factors in determining their efficiency.⁶⁹

Further Reforms of Pension and Health Insurance Systems Will Also Be Required

In addition to the above, reforms of pension systems and (to a lesser extent) health insurance systems in the Region will continue to have significant effects on the labor market. These are direct (for example, with regard to the longer-term incentives for older workers to increase labor force participation) but also indirect (for example, in the large tax burden on labor imposed by social insurance programs in the Region).

Early in the transition period, countries of the Region have recognized the necessity of revising the ongoing pay-as-you-go monopillar pension systems that were under pressure because of a shrinking base of contributions and a growing number of beneficiaries. All countries revised the way benefits were adjusted toward rates that were feasible under available resources. Some also started to increase the retirement age, which was initially low and had even declined in some countries in the early 1990s. Others revised benefits formulae (for example, increasing the reference period). Beyond these initial changes, two groups of countries emerged.

One group of countries (including Albania, Armenia, Azerbaijan, Georgia, and Tajikistan) maintained minimally adequate income floors, which smoothed out any benefit differences resulting from years of contribution or previous earnings. The countries of the second group looked to introduce multipillar systems through shifting a

portion of the mandatory contribution from the public pension to private institutions that established individual defined-contribution accounts for individual workers. As of 2004, nine countries⁷⁰ were already operating second pillars, while FYR Macedonia, Romania, the Slovak Republic, and Ukraine had some legislation about a second pillar. Despite problems, reversals, and some transitional costs, the systems are overall better than the old ones.

Outstanding issues remain, and reforms need to continue to bring full benefits (Holzmann and Hinz 2005). Specifically, three issues arise in the context of this report. First, the evolution of the labor market, combined with the desire to better link benefits with contributions, has left some individuals with inadequate pensions and relying on social safety nets. In a context of increasing real wages, there has been political pressure to increase the indexation of existing pensions, keeping contribution rates high. Although this has so far not threatened the competitiveness of the transition countries (because of their comparatively low wage rates), this trade-off may become binding as wages continue to increase.

Second, more fiscal pressures may arise because of rapidly aging populations and low fertility rates; most countries in the Region will need to continue reforms of the pension system to adjust the system dependency ratio to changing demographics.⁷¹ Further increases in the retirement age may be necessary as life expectancy increases.

Third, countries of the Region also need to undertake other welfare reforms that will stimulate formal sector labor supply to improve the contributions base for a given working-age population. In addition, CEE and SEE countries will need to improve—and in many cases tighten—their eligibility rules and assessment mechanisms within their disability pension programs to avoid an unaffordable dependence on disability benefits by the working-age population. Furthermore, the need for health system reforms that will allow for gradual reduction in health insurance payroll taxes (particularly in SEE) is clear.

Summing Up: The Challenge of Labor Policy Reforms in Transition Economies

This chapter indicates that—like many other areas of the economy and society in transition countries—labor market institutions have been subject to major changes in what is a very short period in international comparative terms. It is likely that the full effects of these reforms have not yet been felt. Overall, CEE and, to a large extent, SEE countries have developed labor market institutions similar to

those in mature market economies. Labor market reforms in Russia, Ukraine, and other CIS countries in contrast have been less thorough, with greater residual institutional rigidities diluted by weak enforcement and high informality. Across the Region, however, the remaining rigidities in labor market institutions continue to have negative impacts on employment outcomes, albeit probably not as acute as sometimes portrayed.

Although labor market institutions cannot be considered as the primary cause of unemployment in the Region, there remains a significant institutional reform agenda across the Region, more so as neighboring EU countries continue labor market liberalization. The specific elements of the agenda and the relative priority between them vary between subgroups, and often within subgroups. General conclusions that are appropriate for each country on all elements of reform are therefore overly ambitious. It is also very clear that labor market institutions and their impact on labor market outcomes constitute an area where substantially more research is needed.

With this major caveat in mind, broad patterns of an agenda for the reform of labor market institutions in the Region and priorities for each subgroup are apparent and will need to be assessed in the light of further research. The key elements of a reform agenda by subgroup are summarized below.

The Labor Market Institutional Reform Agenda in CEE Countries

There is a need for greater adaptability of real wages to productivity. This could be achieved by further decentralization of wage bargaining or by strengthening a social compact that links wage and productivity growth but retains the flexibility for firm bargaining within the aggregate wage adjustment parameter. This should avoid an increased role for sectoral bargaining, which appears to be associated with worse labor market outcomes. In public sector wage setting, there is probably a need for an increased flexibility in wage setting along the model developed (for example) in Estonia. Moreover, there is a need for reconsidering minimum-wage setting, which, albeit not binding on average, may be too high for the low-skilled and for workers in backward areas of many CEE economies. In this context, the possible impact of the rigid link between minimum wage and social benefits should be reassessed.

In the area of employment protection legislation, there is a need to review regulations for permanent employment contracts, which remain overly rigid also in light of the liberalization of temporary

contracts. This should help avoid a significant segmentation of the labor market. There is also a need to further improve labor inspection methods to balance effective enforcement with avoidance of unnecessary impositions on firms, including an increased role for firm self-reporting.

There is also a need to reduce taxes on labor, which are currently very high in CEE, and appear to be a major impediment to increasing employment. However, this will need to be done gradually and in parallel with further reform of pensions and disability and health insurance to balance fiscal requirements, social protection of social insurance beneficiaries, and the need to improve labor market outcomes.

Unemployment benefits have now been reformed in many CEE countries, and their generosity is currently relatively low, limiting possible work disincentives. The main challenge is to strengthen the (re)activation of the long-term unemployed, both through incentives in the benefits and tax systems (for example, back-to-work allowances and tax credits for low-income working households) and through targeting active programs at those groups for whom their net impact is the highest. There is also a need to improve monitoring and evaluation of the effectiveness of different ALMPs to improve their design and targeting efficiency. Moreover, social assistance benefits in depressed regions need to be examined to ensure that eligibility thresholds and benefits levels do not contribute to localized work disincentives.

The Labor Market Institutional Reform Agenda in SEE Countries

Regarding wage determination in SEE countries, there is a need to (a) lessen the role of the government in collective bargaining and strengthen the voice of employers in an attempt to improve the wage and productivity linkage; (b) reduce the scope of general and sectoral collective agreements by promoting greater decentralization of bargaining to the firm level; (c) increase flexibility in minimum-wage setting by allowing for youth minimum wages; and (d) ensure that the minimum-wage-to-average-wage ratio is controlled and, in some countries (for example, BiH), reduced.

Further reform is also needed in the area of employment protection, where regulations on temporary employment contracts remain fairly strict. SEE countries should also ensure that more liberal EPL provisions are not undermined by continued rigidity of employment conditions in collective agreements. This should be accompanied by a

significant improvement in labor inspection practices to balance effective enforcement with the avoidance of unnecessary impositions on firms, including an increased role for firm self-reporting of compliance.

SEE countries should aim for a gradual reduction in payroll taxes, with a particular focus on health insurance taxes. This should be accompanied by efforts to improve compliance on tax payments by firms, including SOEs. Moreover, many countries in this subgroup should improve on the (re)activation of the long-term unemployed, both through incentives in the benefit system (for example, back-to-work allowances) and through targeting ALMPs on those with low skills and in depressed regions. This could also imply some reallocation of funds across activities. This should be accompanied by encouraging private employment agencies to play a role in areas where local labor markets permit.

The Labor Market Institutional Reform Agenda in the Middle and Low Income CIS Countries

This group of countries is even more heterogeneous than the others, and it is thus more difficult to identify common policy objectives. Even so, some common elements could be identified. One concerns the wage-bargaining process, in which most countries in the subgroup should promote better representation of social partners and lower direct intervention from the government. This implies encouraging the emergence of independent unions and employers' associations that will assume a more active role in bargaining and moving away from wage schedules in which all wages are rigidly set as multiples of the minimum wage.

In the area of employment protection, most countries in this subgroup have had more limited reforms, with strict regulations being accompanied by pervasive nonenforcement. Focusing EPL on a core set of labor protections that can be credibly enforced and promoting a reform in labor inspection services could go some way in promoting labor reallocation within the formal sector.

Passive and active labor market programs are less developed in this subgroup than in most of the Region. Given the limited administrative capacity, large underreporting of activities, and limited financial resources, especially in the low income CIS countries, an appropriate choice could be to provide a minimum level of protection for some basic risks. Such protection could be financed through general revenues.⁷² For example, the issue could be raised as to whether a move to flat-rate unemployment assistance is appropriate and whether this might be financed through general revenues, rather than the payroll tax.

More generally, moving toward universal social protection could be considered in some countries. Decoupling minimum pension schemes and health insurance from the labor market status of people (for example, through creating a universal minimum pension or expanding health insurance coverage to informal workers) are options currently under consideration in some emerging economies such as Mexico. Moreover, given widespread informality, the need to reinforce social protection for those without access to formal insurance mechanisms should be considered. This could include greater use of public works schemes that are open to all those willing to work at a program wage rate that is set at a level low enough to ensure self-targeting of the most-needy.

Countries that have not already done so should also consider using alternative approaches to targeting of social transfers, such as proxy means testing or community identification of beneficiaries within national guidelines. Improving targeting for programs aimed at vulnerable groups would enable more efficient redistribution of resources. Regarding social insurance, CIS countries should continue reforms of the pension system that will adjust the system dependency ratio to changing demographics, and encourage other reforms that will stimulate formal sector labor supply to improve the contributions base for a given working-age population.

Annex 6.1: Construction of Employment Protection Legislation Indexes

The indexes are calculated from the raw data provided in the World Bank's Doing Business Database (2005). All the variables range between 0 and 1. Either they are zero-one dummies (no-yes), or they are normalized over the sample. Variables for which higher values (x) represent looser regulations are normalized according to the simple formula (equation 6.1):

$$x_N = 1 - \left(\frac{x - \min(x_E)}{\max(x_E) - \min(x_E)} \right) \quad (6.1)$$

whereas variables for which higher values represent stricter regulations are normalized in the following way (equation 6.2):

$$x_N = 1 - \frac{(\max(x_E) - x)}{(\max(x_E) - \min(x_E))} \quad (6.2)$$

where x_N is the normalized value, $\max(x_E)$ is the maximum value that the variable takes over the sample of countries available from the database, and $\min(x_E)$ is the corresponding minimum value.

The *permanent employment weighted index* is constructed from the raw variables in the following way (weights in parentheses):

Procedures (1/2)	The employer must notify a third party before dismissing one redundant employee. (1/6)
	The employer needs the approval of a third party to dismiss one redundant worker. (1/6)
	The law mandates retraining or replacement before dismissal. (1/6)
	There are priority rules applying to dismissal or layoffs. (1/6)
	There are priority rules applying to reemployment. (1/6)
Firing costs (1/2)	Is redundancy considered a "fair" grounds for dismissal? (1/6)
	Legally mandated notice period for redundancy dismissal (in weeks) after 20 years of continuous employment. Normalized (1/2)
	Severance pay for redundancy dismissal as number of months for which full wages are payable after continuous employment of 20 years. Normalized (1/2)

The *temporary employment regulation index* is equal to the simple average of the following variables:

Fixed-term contracts are only allowed for fixed-term tasks.

What is the maximum duration of fixed-term contracts (in months)? Normalized

Finally, the *overall employment regulation index* is the simple average of the regular and temporary employment indexes.

Notes

1. Useful overviews of institutional issues in the Region's labor markets include Haltiwanger, Scarpetta, and Vodopivec (2003); Boeri and Terrell (2002); Riboud, Sanchez-Paramo, and Silva-Jauregui (2002); Garibaldi and Brixiova (1998); and Svejnar (1999 and 2002).
2. See Blanchflower and Oswald (1998); Köllö (1998); Basu, Estrin, and Svejnar (2004); and Iara and Traistaru (2004).
3. See Ilkcaracan and Selim (2003).
4. See Basu, Estrin and Svejnar (2004) and Flanagan (1998). Poland and (to a lesser extent) Hungary were partial exceptions to this general picture by the end of the communist period.
5. "Union density" refers to the proportion of workers who are members of a union. Union coverage refers to the proportion of workers who are covered by a collective bargaining agreement.
6. See ILO (2002, in Russian). Armenia provides an example of the difficulty of interpreting union density figures in the CIS, with 75 percent union density by official estimates, but 80 percent of workers claiming to "have nothing in common" with trade unions, and half of those claiming to be totally uninformed about unions. Often the inclusion of pensioners and segments of the registered unemployed in union membership numbers also inflates density data.

7. See, among others, EIRO (2004).
8. See Micevska (2004).
9. BiH includes two entities: Republika Srpska and the Federation of Bosnia and Herzegovina.
10. In many countries, this has been in part a political reaction against the “state unions” that monopolized the union movement during the socialist period.
11. See ILO (2002, in Russian) for case studies of CIS country social dialogue.
12. The Russian coefficient system tends to set lower bounds that are very low so that additional payments make up a significant amount of total earnings of public sector employees.
13. See Schiavo-Campo, de Tommaso, and Mukherjee (1997).
14. In many countries that have not reformed public sector pay determination, there has been a significant incidence of payments to employees that are not subject to the coefficient schedule. Such payments have been both formal, through allowances of various forms, and informal, through undisclosed payments to workers.
15. See Schiavo-Campo, de Tommaso, and Mukherjee (1997). By the mid-1990s, the Region’s public-to-private-sector-wage ratio was the lowest of any region, though it was somewhat higher in CEE and SEE.
16. Although there are issues of recording and interpreting data on coverage and density, data generally refer to the formal economy (that is, they include both the state and private sectors).
17. Slovenia has general collective agreements for both the whole public sector and the whole private sector, with sectoral- and company-level agreements (EIRO 2004). The tripartite private sector agreement for 2004–5 includes provisions on principles for pay increases, aggregate increases, minimum increases for all workers, and the minimum wage, among others. These follow the general principle of restraining real-wage growth below productivity growth.
18. See EIRO (various years). Martin and Cristescu-Martin (2002 and 2003) also provide annual updates of developments in CEE industrial relations.
19. This is in contrast to the bulk of EU-15 countries, where wage bargaining takes place primarily at the sectoral level in most countries, though with a trend toward greater decentralization during the 1990s. CEE countries will be subject to social partnership arrangements as part of EU accession.
20. It is estimated that some 30 percent of blue-collar workers and 15 percent of white-collar workers in the private sector in Russia are paid according to public sector wage grids (Kapelyushnikov 2003).
21. See Haltiwanger, Scarpetta, and Vodopivec (2003).
22. See Micevska (2004).
23. See Luke and Schaffer (2000) for Russia, Dobbelaere (2004) for Bulgaria, and Grosfeld and Nivet (1999) and Mickiewicz and Bishop (2003) for Poland. Mickiewicz and Bishop also find that relative rent sharing by workers divides more strongly along old and new firm lines than state and private ones.
24. See Haltiwanger, Scarpetta, and Vodopivec (2003). This association does not necessarily imply causality. The result is at least in part driven by the

coincidence of centralized or coordinated bargaining in Russia and Ukraine with seemingly favorable labor market outcomes (see chapter 2). However, low open unemployment in Russia and Ukraine is mainly the effect of the nature of enterprise restructuring, rather than of the bargaining system. It is also worth noting that although Russia's wage-bargaining system appears centralized on paper, in practice managers have great flexibility at the level of the firm.

25. See OECD (2004a).
26. See Haltiwanger and Vodopivec (2003).
27. See EIRO (2004) for Bulgaria; ONASA (2004) for Bosnia.
28. See Eriksson and Pytlikova (2004).
29. Social benefits were set as a percentage of the "subsistence wage."
30. A minimum social security threshold that exceeds the actual wage implies a higher rate than the nominal tax rate on that wage. In consequence, this may discourage the demand for less-skilled labor.
31. See OECD (2003) for discussion of the Latvia case.
32. See Eriksson and Pytlikova (2004).
33. In some countries, the minimum wage is differentiated according to individuals' education and qualifications. For example, in Montenegro, while the "standard" minimum wage is around 17 percent of the average gross wage, the minimum wage for individuals with a university or higher education degree is at a high 54 percent of the average wage.
34. Kertesi and Köllö (2003) provide evidence on the disemployment effects that the substantial hikes in minimum wage in Hungary had in backward areas in 2001; see Hinnosaar and Rõõm (2003) for Estonia.
35. Recent literature also points to other functions of EPL, including ensuring the income of workers (who are generally risk averse) against labor market uncertainty and providing incentives to employers to internalize the social costs of layoffs in the presence of a higher social than private value of employment. See OECD (2004a); Pissarides (2001).
36. See for example, Nickell (1997).
37. At the same time, the speed of market-oriented reforms, of which labor market reforms are a part, influenced the EU-accession process.
38. Evidence from Argentina, Colombia, France, Peru, and Spain suggests that asymmetric liberalization of contracts has led to significant shifts toward precarious jobs. In Argentina and Spain, these reforms were reversed after a few years, and in the latter, net job creation really picked up only after the government reformed regular contracts in the mid-1990s. In Spain, temporary employment reached almost one-third of the total workforce after the reform of temporary contracts in the mid-1980s (Dolado, García-Serrano, and Jimeno 2002). In Peru, the liberalization of temporary employment in the early 1990s led to an increase in temporary employment from 20 percent in 1990 to 55 percent in 2000. In Colombia, there was a similarly large increase (Saavedra 2003). See also Blanchard and Landier (2002) for France and Hopenhayn (2004) for Argentina.
39. Squire and Suthiwart-Narueput (1995) investigate the impact of labor market regulations in settings where compliance is incomplete.
40. See World Economic Forum (2002).
41. Although neither of these relationships is posited as causal, a link is supported by qualitative assessments.

42. The regressions are done on eight CEE countries: Bulgaria, the Czech Republic, Estonia, Hungary, Poland, Romania, the Slovak Republic, and Slovenia (Haltiwanger, Scarpetta, and Vodopivec 2003).
43. The coordination variable is the simple average of the degree of coordination among employers' associations and trade unions (Haltiwanger, Scarpetta, and Vodopivec 2003).
44. See World Bank (2004c).
45. See Haltiwanger, Scarpetta, and Vodopivec (2003).
46. See Micevska (2004).
47. The calculated tax wedge on labor in reduced form is defined as $(\text{labor cost} - \text{net pay}) / \text{labor cost} * 100$. Labor cost comprises gross wage plus employer payroll contributions on wage. Net pay is calculated as gross wage less employee payroll contributions and personal income tax.
48. The comparison of the tax wedge should be treated with caution because of tax benefits and the treatment of social transfers to families with children, which vary across OECD countries.
49. See Riboud, Sanchez-Paramo, and Silva-Jauregui (2002).
50. See Daveri and Tabellini (1997); Elmeskov, Martin, and Scarpetta (1998).
51. See Haltiwanger, Scarpetta, and Vodopivec (2003); Cazes and Nesporova (2003).
52. Low registered unemployment may lead to artificially high spending per registered unemployed, such as in Russia.
53. See World Bank (2002b).
54. See Haltiwanger, Scarpetta, and Vodopivec (2003). One should bear in mind that reverse causality (endogeneity) may be at work here. Governments often are under pressure to respond to growing unemployment by lengthening the duration of unemployment benefits. This happened, for example, in Poland, where benefit duration is longer in regions of high unemployment. To the extent this is the case, the estimated regression coefficient is biased and overstates the impact of benefit duration on unemployment.
55. See Vodopivec (2004) for a comparative analysis of Estonia and Slovenia.
56. See, for example, Micklewright and Nagy (1996) for Hungary; Ham, Svejnar, and Terrell (1998 and 1999) for the Czech and Slovak Republics.
57. See Atkinson and Micklewright (1992) for pretransition safety net details.
58. See Staines and Isamiddinova (2004).
59. See table 5 in Boeri and Terrell (2002).
60. See Kuddo (2004).
61. See Boeri and Terrell (2002) and Garibaldi and Brixiova (1998).
62. See Boeri (1997).
63. See Commander and Lee (1998) on Russia, and Garner and Terrell (1998) on the Czech and Slovak Republics.
64. This applies to the employment rates of participants and (in some cases) to their postprogram wages.
65. The net impact is lower than the gross impact. The gross impact is the fraction of program beneficiaries who were placed in jobs. The net impact is the gross impact minus the estimated fraction of program beneficiaries

who would have found jobs anyway (the deadweight loss). The deadweight loss can be estimated using experimental or quasi-experimental techniques, as well as econometric methods.

66. See Betcherman, Olivas, and Dar (2004) for a summary of ALMP evaluations, including those for selected countries in the Region. See also Boeri (1997) and Bonin (1999).
67. See Boeri (1997).
68. See Fretwell, Benus, and O'Leary (1999) for cost-effectiveness analysis on ALMPs in CEE countries.
69. ALMPs often have several social and economic goals, which need to be both determined before a new program is designed and taken into account when carrying out impact evaluations.
70. Bulgaria, Croatia, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Poland, and Russia.
71. The system dependency ratio is the ratio of the number of pensioners to the number of contributors to the pension system.
72. There is scope for improving tax collection. For example, De Ferranti and others (2004) propose general principles to improve the efficiency and equitability of taxation in the context of Latin America.